

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

COMMONWEALTH EDISON COMPANY)	
)	Docket No. 15-0287
)	
Annual Formula Rate Update and Revenue Requirement)	
Reconciliation under Section 16-108.5 of the)	
Public Utilities Act)	

**DIRECT TESTIMONY OF MICHAEL L. BROSCH
ON BEHALF OF THE
PEOPLE OF THE STATE OF ILLINOIS AND
THE CITY OF CHICAGO**

AG/City Exhibit 1.0

JUNE 30, 2015

ILLINOIS COMMERCE COMMISSION DOCKET NO. 15-0287
DIRECT TESTIMONY OF MICHAEL L. BROSCHE

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AG/City Exhibit No. 1.5	ComEd response to Data Request AG 5.10

I. INTRODUCTION / SUMMARY

1 **Q. Please state your name and business address.**

2 A. My name is Michael L. Brosch. My business address is PO Box 481934, Kansas
3 City, Missouri 64148-1934.

4
5 **Q. By whom are you employed and in what capacity?**

6 A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in
7 utility rate and regulation work. The firm's business and my responsibilities are
8 related to the conduct of regulatory projects for utility regulation clients. These
9 services include rate case reviews, cost of service analyses, jurisdictional and class
10 cost allocations, financial studies, rate design analyses, utility reorganization
11 analyses, the design and administration of alternative regulation mechanisms, and
12 focused investigations related to utility operations and ratemaking issues.

13 **Q. On whose behalf are you appearing in this proceeding?**

14 A. I am appearing on behalf of the People of the State of Illinois represented by the
15 Attorney General ("AG") and the City of Chicago (the "City").

16 **Q. Will you summarize your educational background and professional experience**
17 **in the field of utility regulation?**

18 A. Yes. AG/City Exhibit No. 1.1 summarizes my education and professional
19 qualifications. I have testified before utility regulatory agencies in Arizona,
20 Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan,
21 Missouri, New Mexico, Ohio, Oklahoma, Texas, Utah, Washington, and Wisconsin
22 in regulatory proceedings involving electric, gas, telephone, water, sewer, transit,
23 and steam utilities. A listing of my previous testimonies in utility regulatory
24 proceedings is set forth in AG/City Exhibit No. 1.2. As noted in this listing, I have

testified in several major Illinois proceedings before the Illinois Commerce Commission (“the Commission” or “ICC”), including multiple cases involving Peoples Gas Light & Coke Company, North Shore Gas Company, Commonwealth Edison Company (“ComEd” or the “Company”), and the Ameren Illinois Utilities (“Ameren”). Those cases include each of the prior four rounds of formula rate case proceedings for ComEd and Ameren, Docket Nos. 11-0721, 12-0321, 13-0318, 14-0312, 12-0001, 12-0293, 13-0301, and 14-0317. I also provided testimony in the Commission’s Investigation Docket No. 13-0533 addressing certain formula rate template issues, including consideration of the need to apply interest to reconciliation balances on a net of income tax basis.

Q. What is the purpose of your testimony in this docket?

A. My testimony is responsive to the formula rate and revenue requirement calculations of ComEd that are sponsored by various Company witnesses and are summarized in ComEd Exhibit 2.01.¹ I have included as AG/City Exhibit 1.3 a summary of ratemaking adjustments to ComEd’s formula rate update calculations, excluding the AG/City proposed change to the reconciliation interest calculation discussed below. I have also incorporated within AG/City Exhibit 1.4 excerpts from my previous Direct and Rebuttal Testimony in Docket No. 13-0553 regarding the treatment of Accumulated Deferred Income Taxes (“ADIT”) that are associated with the formula rate reconciliation balance.

Q. Please summarize the recommendations that are set forth in your testimony.

¹ ComEd Exhibit 2.01 contains the overall formula rate template calculations and is supported by workpapers contained in ComEd Ex. 2.02 as well as multiple other exhibits.

46 A. I have previously testified that, when the cash recovery of a portion of an electric
47 utility's revenue requirement is delayed under the formula rate reconciliation
48 process used in Illinois, the utility's taxable income is temporarily reduced and
49 income tax payments are deferred until future periods when the revenues are
50 collected. Unfortunately, the Commission concluded in a recent review of
51 ComEd's formula rate template, Docket No. 13-0553, that ADIT balances arising
52 from the delayed recovery of reconciliation revenues should not serve as an offset
53 to the reconciliation balance that accrues interest. The Commission's determination
54 on this matter was appealed by the Attorney General and other parties to Docket
55 No. 13-0553, and a ruling on review is pending.

56 I sponsored Direct and Rebuttal Testimony in Docket No. 13-0553
57 explaining why it is appropriate to apply reconciliation interest to the reconciliation
58 revenues net of associated deferred income taxes ("ADIT"). I also sponsored
59 certain edits to formula rate Schedule FR A-4, within AG/City Exhibit 1.7 in that
60 prior docket, illustrating how to implement the net-of-tax calculation of interest on
61 the reconciliation balance. A copy of relevant portions of my Docket No. 13-0553
62 testimony and AG Exhibit 1.7 from that prior docket are included in AG/City
63 Exhibit 1.4. Those excerpts detail the need for that adjustment in any formula rate
64 update case and preserve this disputed issue within the record of the instant
65 proceeding, in case there is any Appellate Court ruling in favor of the Attorney
66 General.

67 I also propose an adjustment to the input value for the State of Illinois
68 Corporate Income Tax that is used within the formula rate template. The currently
69 effective statutory Illinois corporate income tax rate is 7.75 percent, which should

be used to establish the Company's revenue requirement, rather than the temporarily higher 9.5 percent rate from 2014 that is no longer in effect, but has been employed by ComEd in its formula rate calculations in the instant case.

I also explain in my testimony that one element of ADIT, arising from ComEd's non-tax-deductible provision for uncollectible accounts, should not be used to increase rate base, because the corresponding uncollectible reserve account is not used to reduce rate base.

Q. What information have you relied upon in formulating your recommendations?

A. I relied upon ComEd's pre-filed testimony and exhibits in this Docket, as well as the Company's responses to data requests submitted by the Commission Staff and the AG. I have referenced a copy of Section 16-108.5 of the Public Utilities Act, 220 ILCS 5/16-108.5, which was provided to me by counsel. I also rely upon my prior experience with the regulation of public utilities over the past 36 years, including significant experience with alternative forms of regulation for energy utilities in Illinois and other states.

Q. Have you prepared any accounting schedules to summarize the adjustments being proposed in your testimony?

A. Yes. AG/City Exhibit 1.3 is a summary of the revenue requirement revisions being proposed in my testimony and in the testimony sponsored by David Effron, excluding the reconciliation interest calculation modification proposed by Mr. Effron and by me. On the final four pages of my Exhibit 1.3, modifications to input values on the Company's formula rate update filing sheets are indicated by outlining cells in red. It should be noted that Mr. Effron and I have not, with

available time and resources, been able to conduct a complete review of all aspects of the Company's filing. As a result, the limited adjustments we propose should be viewed as cumulative with the work and recommendations of Commission Staff and other parties' witnesses.

II. RECONCILIATION DEFERRED TAXES

Q. In the previous ComEd formula rate update proceeding, Docket No. 13-0318, did you recommend a modified ratemaking treatment for a specific element of the Company's recorded ADIT balance?

A. Yes. In my prior testimony² I recommended that the Commission reduce the reconciliation balance to which the interest rate is applied, to recognize the Company's actual incremental investment in such balances after the deferral of income taxes is considered.

Q. Did the Commission address your recommendation in its Final Order in Docket No. 13-0318?

A. No. In its Final Order in Docket No. 13-0318, the Commission stated, "The proposal to consider and change the structure and protocols of ComEd's formula rate related to the calculation of deferred income taxes on reconciliation balance are beyond the scope of this Section 16-108.5(d) annual update and reconciliation

² Docket No. 13-0318, AG Exhibit 1.0, pages 18-26.

proceeding.” This issue was ultimately considered by the Commission and decided
in Docket No. 13-0553.³

**Q. What did the Commission decide with respect to reconciliation-related ADIT
balances in Docket No. 13-0553?**

A. The following statements are set forth in the Commission Analysis and Conclusions
discussion of income tax deferrals associated with the reconciliation balance interest
calculations:

The Commission disagrees with Staff and ComEd
that the language in Section 16-108.5(d)(1) is clear or
unambiguous on the subject of the appropriate accounting
treatment that should be applied to the over-collection or under-
collection balance in a reconciliation proceeding under formula
rates. The Commission finds merit in the AG and CCI’s⁴ proposal
that accumulated deferred income tax, or ADIT should be netted
against the reconciliation balance before calculating the interest
amount. This concept is consistent with Generally Accepted
Accounting Principles, is consistent with standard regulatory
practice that matches ADIT elements to the associated assets
included in rate base and properly recognizes the cash benefit to
the utility that would otherwise have been paid out for income
taxes on the amount.

While there may be merit to the AG and CCI’s
proposal and while there may be some debate as to the plain
meaning of the Act, the Commission is troubled by the fact that
although Section 16-108.5(d)(1) fails to prohibit such accounting
treatment, the converse is also true—it does not appear to require
or even reference it. Further, as ComEd points out, where the Act
does intend that adjustments be made to an amount of a balance, it
has done so specifically, as in the case of projected plant additions
which are to be included on a net basis considering updated
depreciation reserve and expense, 220 ILCS 5/16-108.5(c)(6), or in
the ROE collar calculation where the utility is required to apply a
credit or charge that “reflects an amount equal to the value of that
portion of the earned rate of return on common equity that is more
than 50 basis points higher [or lower] than the rate of return on

³ Order, Docket No. 13-0318, December 18, 2013, page 63.

⁴ “CCI” was a coalition of parties in Docket No. 13-0553 that included the City of Chicago, the Citizens Utility Board, and the Illinois Industrial Energy Consumers.

common equity calculated pursuant to paragraph (3) of this subsection (c)...for the prior rate year, adjusted for taxes.” 220 ILCS 5/16-108.5(c)(5).

The Commission would note that this is not the first time the clarity of this subsection concerning the reconciliation balance has been called into question and that the legislature has already once amended it. Thus, it is difficult for the Commission to support an interpretation of the Act which reads into it exceptions, limitations, or conditions the legislature did not express. Davis v. Toshiba Machine Co., 186 Ill.2d 181, 184-185 (1999). Considering all the arguments presented regarding the meaning of Section 16-108.5(d)(1), the Commission cannot at this time support the AG and CCI’s interpretation. For purposes of this proceeding, ComEd is entitled to the full reconciliation balance with interest calculated at a rate equal to the utility’s weighted average cost of capital approved by the Commission for the prior year. 220 ILCS 5/16-108.5(d)(1). In the future, if further arguments from the parties are presented or clarity from the legislature is provided on this topic, the Commission will revisit the issue.⁵

On advice of counsel, I understand that this decision by the Commission has been appealed and remains under review by the Illinois Appellate Court, First Judicial District, docketed as Nos. 1-14-0275 and 1-14-0403 (cons.) and has been fully briefed by the parties.

Q. Did the Commission address the appeal of the reconciliation deferred tax issue in ComEd’s most recent formula rate update proceeding?

A. Yes. In its Final Order in ComEd Docket No. 14-0312, the Commission stated, “[t]he decision in Docket No. 13-0553 has been appealed and if it is overturned, then ComEd is directed to recalculate the interest on the reconciliation balance, consistent with the AG/CCI proposal.”⁶

Q. What are the documents that are included within AG/City Exhibit 1.4?

⁵ Docket No. 13-0553, Final Order dated November 26, 2013, page 43.

⁶ Order dated December 10, 2014, Docket No. 14-0312, at 77.

184 A AG/City Exhibit 1.4 contains copies of excerpts from my Direct and Rebuttal
185 Testimony that were filed in Docket No. 13-0553 to address the reconciliation
186 deferred income tax issue mentioned above. AG/City Exhibit 1.4 also contains a
187 copy of the modified formula rate template Schedule FR A-4 that I sponsored in that
188 earlier docket to illustrate exactly how to modify the reconciliation calculation so as
189 to implement the adjustment proposed by myself and by Mr. Effron.

190 **Q. Why have you included excerpts of previous testimony you submitted to**
191 **address this issue?**

192 A. I am advised by counsel that this information may be useful to the Commission if it
193 wishes to revisit this issue or in the event the Appellate Court issues a decision on
194 this disputed issue. I am hereby adopting my prior testimony excerpted in AG/City
195 Exhibit 1.4 as part of my direct testimony in this proceeding. The same proposed
196 adjustment is also discussed in the direct testimony of AG/City witness David Effron,
197 AG/City Exhibit 2.0. Mr. Effron quantifies the effect of the adjustment in this instant
198 formula rate update case.

199

200 **III. STATE INCOME TAX RATE**

201

202 **Q. What is the currently effective Illinois Corporate State Income Tax rate?**

203 A. The currently effective State Income Tax (“SIT”) rate is 7.75 percent, comprised of
204 a tax on corporate Net Income of 5.25 percent plus Personal Property Tax
205 Replacement Income Tax at a rate of 2.5 percent. Prior to January 1, 2015, an

206 overall SIT rate of 9.5 percent was in effect, including income tax at 7.0 percent
207 plus Personal Property Replacement Income Tax of 2.5 percent.⁷

208 **Q. What SIT rate has been included by ComEd in the determination of formula**
209 **rates to be charged in 2016?**

210 A. ComEd's formula rate calculations generally use the higher 9.5 percent SIT rate that
211 was effective prior to January 1, 2015 to calculate both the 2014 reconciliation year
212 and the 2016 Initial Rate Year revenue requirement. The use of this higher rate can
213 be observed in ComEd Ex. 2.01, page 13 (Sch. FR C-4) at line 2 and in ComEd Ex.
214 2.02 at page 143 (WP 21) at line 2. However, at ComEd's Schedule C-5.3 that sets
215 forth "Differences Between Jurisdictional 2014 Book and Tax Depreciation," the
216 Company uses a 7.48 percent "State Income Tax Rate" at line 7 that is applied to
217 the "Tax Depreciation for State Tax – Net Add/(Deduct)" amount of \$191.8
218 million.

219 **Q. Will the use of the 2014 SIT rate of 9.5 percent in the determination of the**
220 **Company's revenue requirement, as proposed by ComEd, result in excessive**
221 **charges to ratepayers in 2016, when new electric delivery service rates become**
222 **effective?**

223 A. Yes. The higher 2014 SIT should not be used for either the 2014 reconciliation
224 year or for the determination of Initial Rate Year 2016 charges. The currently
225 effective SIT rate is the appropriate input to the formula rate template at this time.

226 **Q. Why should the higher 2014 SIT rate of 9.5 percent not be used to calculate the**
227 **reconciliation revenue requirement for calendar year 2014, since the higher**
228 **rate was effective that year?**

⁷ 35 ILCS 5/201(a)(11) and 5/201(d).

229 A. Stated simply, ComEd has no State income taxes payable for the reconciliation year
230 2014 for its delivery service revenue requirement, because its delivery service
231 taxable income in 2014 was negative. This means that all of the Company's
232 calculated State income taxes for 2014 were "deferred" income taxes that will be
233 payable in later years, under the lower SIT rates effective at that time. Negative
234 currently payable (for 2014) State income taxes can be observed throughout the
235 Company's filing, including the following schedules and exhibits:

- 236 • Schedule C-1 FY, page 1, line 20
- 237 • Schedule C-1 RY, page 1, line 20
- 238 • Schedule C-5 FY, page 4, lines 87 and 88
- 239 • Schedule C-5 RY, page 4, lines 87 and 88
- 240 • Schedule B-8 FY, page 1, line 27
- 241 • Schedule B-8 RY, page 1, line 27
- 242 • ComEd Ex. 2.01, page 19 (App 3), lines 29 and 69
- 243 • ComEd Ex. 2.02, page 25 (WP 3 p.9), line 20

244 When deductions for accelerated depreciation and other book/tax timing differences
245 allow ComEd to defer the payment of State income taxes on delivery service
246 business operations to years after 2014, the Company will permanently save on
247 such taxes by paying in future years when, if no changes are made, SIT rates will be
248 lower.

249 Additionally, when the incremental revenues sought by ComEd in its
250 filing for both years are actually collected from ratepayers in 2016, the effective
251 SIT rate will be 7.75 percent, rather than the higher 2014 rate being used by
252 ComEd.

253 **Q. Why has ComEd applied the higher 9.5 percent statutory tax rate to its**
254 **determination of revenue requirements?**

255 A. According to the Company's response to data request AG 5.10(d), the Company
256 believes that inclusion of the currently effective SIT rate to determine the revenue
257 requirement to be charged in 2016, "...would require a change to the established
258 formula structure" and the Company contends that because the calculation of Initial
259 Rate Year revenue requirement, "...is an estimate that will ultimately be reconciled
260 in any event (with interest), it is unnecessary to change the Illinois state income tax
261 rate related to the Initial Rate Year." A full copy of this response is included within
262 AG/City Exhibit 1.5.

263 **Q. Is there a need for any change to the "established formula structure" to**
264 **recognize the reduced 7.75 percent SIT rate?**

265 A. No. The currently effective 7.75 percent SIT rate can be entered as an input directly
266 into Sch. FR C-4, line 2, where ComEd is now using the higher 9.5 percent rate. I
267 have illustrated this change within the red-outlined cell of AG/City Exhibit 1.3,
268 page 3 of 6. Moreover, even if a change to the organization of Schedule FR C-4
269 were needed (which it is not), I am advised by counsel that Schedule FR C-4 is not
270 part of the formula rate "structure," according to the Commission's final order in
271 Docket No. 14-0316.⁸

272 **Q. Is it reasonable to employ the statutory 7.75 percent SIT rate effective in 2015**
273 **for the reconciliation year 2014, even though the statutory rate in that year**
274 **was higher?**

⁸ Order dated November 25, 2014, Docket No. 14-0316, at 18.

275 A. Yes. As noted above, partly because of the temporary effect of timing differences
276 between the recognition of certain expenses under tax accounting and under accrual
277 accounting, ComEd's delivery service business operation experienced negative state
278 taxable income and negative currently payable Illinois Corporate Net Income Tax in
279 2014. Because affected tax payments are delayed, but not avoided, more than 100
280 percent of the Company's 2014 State Income Tax Expenses are deferred income
281 taxes that will become payable in future tax years. The Company will, therefore,
282 pay no income taxes at the higher 9.5 percent SIT rate that was effective in 2014,
283 but will instead will pay the State at the lower SIT rates that are effective after
284 2014, when the deferred income taxes that were recorded in 2014 later become
285 payable.

286 **Q. What are deferred income taxes?**

287 A. Deferred income taxes represent an accounting provision for the amounts of
288 additional income taxes that are estimated to become receivable or payable in future
289 periods, because of differences between book accounting and income tax
290 accounting with respect to the timing of revenue or expense recognition. Generally
291 Accepted Accounting Principles ("GAAP") require use of an accrual basis
292 accounting method that must be used to recognize revenues, expenses, and income
293 within the publicly issued financial statements of public utilities such as ComEd. In
294 contrast, the accounting methods and procedures specified to determine revenues
295 and expenses (deductions) and taxable income for income tax purposes are defined
296 by the Internal Revenue Code ("IRC" or "Code") and applicable State laws.

297 Differences in GAAP versus Code accounting cause what are
298 characterized as book/tax differences. Many of these book/tax differences are

temporary because they arise from timing differences, where a specific cost is deductible for tax purposes in a different year than for book purposes – the primary example being depreciation expenses that are recorded on a straight-line basis for book accounting, but are based upon accelerated lives and methods and/or “bonus” depreciation methods for income tax accounting and reporting purposes. Timing differences can also occur where the book basis of depreciable property includes different costs than the tax basis or whenever an anticipated expense is recognized on an accrual-basis for book purposes, but is deductible in a different year, when the expense is actually paid in cash by the taxpayer.

Specific provisions within GAAP⁹ require recognition of income tax impacts from these book/tax timing differences, by recording deferred tax expense or income with the other “side” of this entry contributing to ADIT assets or liabilities. ADIT assets generally occur when revenue taxation occurs prior to book recognition of the revenues or when the tax deductibility for expenses is later than the book recognition of the expense. ADIT liabilities, on the other hand, represent delayed taxation of revenues or advance deduction of expenses, in relation to the timing of the same transactions on the books. ADIT balances exist to recognize that certain tax expenses are determinable today, but actually become payable in the future whenever book/tax timing differences ultimately reverse.

Q WHY IS ACCOUNTING FOR ADIT REQUIRED UNDER GAAP?

A Full and complete accounting for income tax expenses must recognize that filing tax returns and paying income taxes will impact tax expenses payable in more than

⁹ GAAP accounting requirements for Income Taxes are set forth within Financial Accounting Standards Board Accounting Standards Codification 740.

one accounting period. The relevant GAAP requirements are stated within Accounting Standards Codification 740 ("ASC 740"). Under ASC 740, there are two primary objectives related to accounting for income taxes:

- a. To recognize the amount of taxes payable or refundable for the current year; and,
- b. To recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns.

Recorded ADIT amounts arise from part (b) of this standard, where recognition is given on the books to the future tax consequences of transactions that are treated differently in financial statements than on tax returns.

Q. Under GAAP, should Deferred Income Taxes be recorded at the presently effective tax, or at the income tax rate that is expected to be effective in the future, when book/tax timing differences reverse and the tax impacts become currently payable?

A. Expected income tax rates are required to be used in recorded deferred income taxes. GAAP accounting requires a liability method approach to deferred tax recognition, so as to record the best available estimate of the taxes that will actually become payable or receivable in future years, at then current tax rates. Specifically, ASC 740-10-10-3 states:

10-3 Conceptually, a deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. That concept is an incremental concept. A literal application of that concept would result in measurement of the incremental tax effects as the difference between two measurements:

- 348 a. The amount of taxes that will be payable or refundable in
349 future years inclusive of reversing temporary differences and
350 carryforwards.
351
352 b. The amount of taxes that would be payable or refundable in
353 future years exclusive of reversing temporary differences and
354 carryforwards.
355

356 However, in light of the constraints identified in the preceding
357 paragraph, in computing the amount of deferred tax liabilities and
358 assets, the objective is to measure a deferred tax liability or asset
359 using the enacted tax rate(s) expected to apply to taxable income in
360 the periods in which the deferred tax liability or asset is expected to
361 be settled or realized. [emphasis added]¹⁰
362

363 **Q. Has ComEd recognized this GAAP requirement with regard to the SIT rate**
364 **used on its books to record deferred income taxes at the tax rates expected to**
365 **be effective in future years?**

366 A. Yes. At ComEd Ex. 2.02, page 82 (WP 9) the Company proposes a downward
367 adjustment to income tax expenses for SIT rate differences at line 14 that is
368 captioned, “Difference between Current and Deferred state rate and flow through
369 items” in the jurisdictional amount \$10.138 million. Footnote 1 on WP 9 explains
370 this adjustment, stating that it “[r]epresents the impact that the change in IL tax
371 rates has on current year temporary and flow through items. The benefit is arrived
372 at by taking the difference between the temporary items measured at the tax rate
373 currently in place and the tax rate enacted in the year these items are expected to be
374 realized. This also includes a one-time tax adjustment to account for the impact of
375 the IL rate change on our existing deferred balances at December 31, 2013.”

¹⁰ Financial Accounting Standards Codification 740-10-10-3. The reference to the “preceding paragraph” refers to constraints associated with knowledge about future conditions. Specifically, ASC 740-10-10-2(c) states, “Information about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.”

Similarly, for the depreciation-related deferred tax provision summarized in Schedule C-5.3, the 7.48 percent rate on line 7 represents a blend of expected future SIT rates scheduled to be in effect when the depreciation related book/tax timing differences on long-lived utility property reverse and taxes deferred for the higher tax depreciation today become payable in future years.

Q. If ComEd has already adjusted downward certain of its deferred tax expenses on WP 9 to recognize the decline in SIT rates after 2014, why is your proposed SIT rate adjustment at Sch. FR C-4 necessary?

A. The Company's WP 9 reduction to income tax expenses, which is posted at Sch. FR A-1, line 19, captures only the incremental reductions to recorded ADIT balances that are needed to recognize lower future SIT rates that are scheduled to be effective when prior years' book/tax timing differences reverse. The WP 9 adjustments to recorded ADIT balances appear to be backward looking, restating only the Company's per book actual ADIT balances at December 31, 2014 to account for scheduled reductions in SIT rates. What is needed is a full accounting for the overstatement of State Income Taxes within the Company's asserted revenue requirement that will result from the formulaic application of SIT rates. This full accounting for the tax rate change is provided by changing the input tax rates on Schedule FR C-4, as proposed in my adjustment. The Company's proposed formula rate calculation determines the revenue requirement using the higher statutory tax rates that are entered at Sch. FR C-4. This calculation embeds incremental income taxes, at the input tax rates on Sch. FR C-4, on the entire revenue requirement, including the full amount of any needed rate increase that will be collected entirely in future periods, when actual SIT rates are lower. The relevant formula

calculations can be observed within the “After Tax Return on DS Rate Base” on Sch. FR A-1, which is multiplied by an “Incremental Tax Gross Up Factor (%)” to include Federal and State Income taxes captioned as “Incremental Tax Gross Up,” at lines 16, 17 and 18, respectively. The same sequence of calculations appears on Sch. FR A-1-REC for the reconciliation period.

This process embeds within both the prospective and reconciliation revenue requirements higher income taxes at 2014 statutory rates on the entire amount of annual revenues being sought by ComEd, even though some of that revenue requirement will actually be collected (and subject to income tax) in years subsequent to 2014 when SIT rates are lower. The Company’s tax adjustments at WP 9 do not have this effect and must be reconciled to the revenue requirements resulting from the incorrect application of the 2014 SIT rate in determining rates and revenues that will be taxed entirely at the lower, currently-effective SIT rates.

Q. How should the adjustment you propose be implemented?

A. The “Illinois State Tax Rate (%)” used as an input to the formula on Sch. FR C-4, line 2 should be revised to 7.75 percent. Making this adjustment to ComEd Ex. 2.01 reduces the Company’s asserted net revenue requirement by the amounts shown on line 6 of AG/City Exhibit 1.3.

Then, ComEd’s WP 9 adjustment to income tax expense may require revision to conform it to utilization of currently effective SIT rates in the template calculation.

Because of the absence of detailed support for the jurisdiction amount input by

421 ComEd at WP 9, line 14, any required revisions to this entry cannot be determined
422 at this time.¹¹

423 **Q. Will the revenue requirement impact of recognizing the lower SIT rate vary,**
424 **depending upon the Commission findings on other issues in this proceeding?**

425 A. Yes. The SIT rate change I recommend should be applied after any adjustments to
426 rate base that may be ordered by the Commission, in determination of the revenue
427 requirement within the reconciliation and rate year calculations.

428

429 **IV. BAD DEBT DEFERRED TAXES IN RATE BASE**

430

431 **Q. Earlier in this testimony, you explained why it is necessary to account for**
432 **deferred income taxes. Why do we care about ADIT balances in determining**
433 **utility revenue requirements?**

434 A. Utilities are capital-intensive businesses that invest continuously in newly
435 constructed or acquired assets. These large annual capital investments generate
436 persistently large income tax deductions for bonus/accelerated depreciation and
437 other tax deductions and credits that must be normalized by recording ADIT. The
438 requirement for normalization accounting denies ratepayers any immediate flow-
439 through benefit from such tax deduction, because deferred income tax expense
440 accruals are included as part of total income tax expense in the revenue
441 requirement. From a ratemaking perspective, a utility's persistently large credit
442 ADIT balances caused by the deferred payment of recorded tax expenses represent

¹¹ Data Request AG 7.01 was submitted to ComEd on June 24, 2015 to elicit additional information regarding the Company's WP 9 income tax adjustment and was unanswered at the time this testimony was finalized on June 30, 2015.

a significant source of capital to the utility. ADIT balances represent a form of zero-cost capital to the utility created by the income tax savings permitted under tax laws and regulations that are not immediately “flowed through” to ratepayers and would benefit only shareholders unless properly recognized as a rate base reduction. ADIT balances are normally included in rate base as reductions by regulators, so as to properly quantify the net amount of investor-supplied capital to support rate base assets.

Q Has ComEd included its ADIT balances in the determination of its rate base?

A Yes. At ComEd Ex. 2.01, page 8, Sch. FR B-1, at line 17, the Company has included ADIT balances that reduce Rate Base by approximately \$3.1 billion, with additional summarized supporting data at page 21, App 4. More detailed supporting data is set forth in ComEd Ex. 2.02, (WP 4) pages 26 through 29, showing how individual elements of recorded ADIT balances were treated in determining the rate base includable amount.

Q Did the Company include all of the elements of its ADIT balances that are recorded on its books and that are listed in ComEd Ex. 2.02 within its proposed rate base?

A No. The Company evaluated the more than 100 elements of book/tax timing differences listed within ComEd Ex. 2.02 (WP 4) and has included many, but not all, elements of its recorded ADIT balances for rate base inclusion, either on an allocated or 100 percent DST assignment basis.¹² Generally, the ADIT items not included in ComEd’s proposed rate base are related to transactions or specific costs

¹² These line items are designated within columns labelled “Allocator” and “Percentage” within ComEd Ex. 2.02.

465 that are treated as non-jurisdictional or that are otherwise excluded in determining
466 the Company's rate base.

467 **Q Have you reviewed the Company's listing of ADIT detailed accounts to**
468 **evaluate whether the proper elements have been recognized in rate base?**

469 **A** Yes. I reviewed ComEd's referenced WP 4 classifications and the Company's
470 overall revenue rate base calculations to determine whether any inconsistent
471 treatments of ADIT are proposed by the Company.

472 **Q Do you disagree with any of the Company's proposals regarding ADIT**
473 **amounts for specific book/tax timing differences that ComEd has either**
474 **included or excluded in determining rate base?**

475 **A** Yes. I am proposing the elimination of the ADIT element captioned, "Provision for
476 Bad Debt" that appears at line 8 of ComEd Ex. 2.02, page 26. This ADIT amount is
477 associated with the Company's accrual basis accounting provisions for Bad Debts,
478 also known as "Uncollectible Accounts", and serves to overstate ComEd's asserted
479 Rate Base by approximately \$18.5 million.

480 **Q. Why are there ADIT amounts associated with ComEd's "Provision for Bad**
481 **Debt"?**

482 **A** Bad debts are deductible for income tax purposes at the time an amount owed to the
483 taxpayer actually becomes worthless.¹³ However, Generally Accepted Accounting
484 Principles require the recognition of bad debts on an accrual basis of accounting,
485 well in advance of when customer accounts are actually charged off as worthless.
486 This difference in accounting creates a book/tax timing difference for which ADIT
487 amounts are recorded. Because the bad debt amounts are accrued before they are

¹³ 26 C.F.R. § 1.166-1.

actually charged off as worthless and recognized for tax purposes, the effect is a delayed tax deduction, which increases rate base. Specifically, the recorded accruals that provide for estimated future bad debt account write-offs are not tax deductible, but the later actual write-off are deductible.

Q. Please explain how bad debts are recorded on the books.

A. In compliance with GAAP and the prescribed Uniform System of Accounts, utilities record on their books a “provision for bad debts” on an estimated basis, as a charge to Account 904 “Uncollectible Accounts,” with a corresponding credit to Account 144, “Accumulated Provision for Uncollectible Accounts – credit.”¹⁴ This Accumulated Provision credit account then serves as a valuation offset to the utility’s Account 142 “Customer Accounts Receivable” balances, to include in the utility’s balance sheet only the estimated realizable net value of Accounts Receivables, after consideration of expected uncollectible portion recorded therein. The Account 144 provision for uncollectibles thus reduces the utility’s reported assets. Then, when any specific customer’s account balance later becomes worthless and must be written off, the Account 142 value of the customer’s account is reduced and the Account 144 Accumulated Provision balance is charged the same amount.

Q. Why should ComEd’s ADIT balance arising from per book provisions for bad debts, in excess of deductible write-off amounts, not be included in rate base?

A. The positive (or debit) ADIT amounts arising from the Company’s Provision for Bad Debts have the effect of increasing Rate Base. Those amounts should not be

¹⁴ These accounts are prescribed for this use in the Federal Energy Regulatory Commission’s Uniform System of Accounts, 18 C.F.R. § 1.101.

510 included in Rate Base, as proposed by ComEd, because the corresponding
511 Accumulated Provision for Uncollectibles credit balance in Account 144, which
512 would have the effect of reducing rate base, has not also been included in Rate
513 Base. It is fundamentally unfair to increase Rate Base for bad-debt-related ADIT
514 amounts when the associated accounting reserve balance arising from accrual-basis
515 accounting for bad debts is not used to reduce Rate Base.

516 **Q. Is there another reason to exclude Bad Debt-related ADIT balances in**
517 **determining the Company's Delivery Service jurisdictional Rate Base?**

518 A. Yes. Bad debt expenses are not includable within the Delivery Service revenue
519 requirement at all, but are instead collected through Rider UF. ComEd Ex. 2.01,
520 pages 24-25 (App 7) reflects the removal of "Uncollectible Accounts" expense of
521 approximately \$45.1 million that is explained in footnote 1 as, "Account 904,
522 Uncollectable accounts have been removed and are recovered through Rider UF."

523 **Q. Does this conclude your testimony at this time?**

524 A. Yes.